FitchRatings

Fitch: Detroit Water/Sewer Tender Would Not be a Distressed Debt Exchange

Fitch Ratings-New York-21 August 2014: The City of Detroit's (Detroit) Aug. 7 tender offer for all Detroit Water and Sewerage (DWSD) bonds, if fully executed, would not constitute a distressed debt exchange (DDE), according to Fitch Ratings.

The tender invitation, made through and with the approval of its various officials, includes the Bonds proposed to be impaired under the Fifth Plan of Adjustment (POA) and those that were listed as unimpaired. Fitch has evaluated the terms of the tender offer in the context of Detroit's bankruptcy.

The tender offer is not an attempt to avoid a payment default or default on other terms of the DWSD Bonds. The proposed treatment in the POA was intended to create an opportunity to call bonds at par that are not currently callable, to achieve savings, and to facilitate a potential conversion of DWSD to a regional utility or, more remotely, a privatized utility. It was not motivated by any financial distress within the DWSD itself. The tender offer is not conditioned on the tendering bondholders agreeing to any amendments to the indenture that would impair the rights of non-tendering holders.

The offered tender prices are intended to reflect current market prices. Additionally, roughly 90% of the bonds proposed to be impaired under the POA would be purchased at par or higher prices. Two percent of the proposed impaired bonds with tender prices below par are Capital Appreciation Bonds with maturities between 2016-2021, and those tender prices are more reflective of the current accreted value as opposed to the full value at maturity.

Further, bond prices below par appear in both the proposed unimpaired and impaired classes of the bonds. As noted in Fitch's DDE criteria, a cash tender below par is not a DDE unless combined with a consent solicitation to amend restrictive covenants (that would impair rights of non-tendering bondholders).

If the tender process is completed, Detroit will amend its POA and list all DWSD Bonds as unimpaired. Detroit intends to currently refund the tendered bonds that are purchased. Detroit has a conditional commitment from financial institutions to purchase the refunding bonds used to pay the purchase price. Bonds that are not tendered will not be altered and will continue to be entitled to payment of scheduled principal and interest according to the original terms.

The Bonds are revenue bonds of the respective water and sewer system (the System) secured by first or second liens, as the case may be, on the net revenues of the respective entity. A key assumption underpinning the ratings currently maintained is that the bonds constitute "special

revenue obligations" under Chapter 9 of the US Bankruptcy Code. As such, in Fitch's view, they are legally protected from impairment in Detroit's Chapter 9 proceedings given the clear intent in the Bankruptcy Code to carve out debt secured by special revenues.

The POA, however, listed about 43% of these Bonds (by par value) as impaired based on a proposal to remove the call protection, reduce interest coupons and subordinate bondholder security interests in certain circumstances. The bondholders rejected the POA. The bond trustee, an ad-hoc committee of certain large bondholders and others have filed objections to the POA, which has raised material legal issues. Fitch's believes the impairment to the Bonds would likely be resolved against Detroit if pursued fully in the judicial process.

The failure of the tender offer or its rejection by Detroit will not result in the DWSD defaulting on the special revenue obligations. It would restore the parties to the terms of the POA and the DWSD Bond impairment could only then be confirmed by cramming down the DWSD bondholders. Fitch does not view confirmation of the plan and such a cram down to be a likely outcome.

Fitch notes that under Michigan law, all bonds are payable solely from the pledged System net revenues. The DWSD bonds are secured by a statutory lien on the pledged net revenues. Under Detroit charter, revenues collected for the Systems can only be used exclusively for the Systems and their debt and not in support of operations of Detroit unrelated to the Systems. Fitch also notes that certain federal court orders require Detroit to treat the enterprises separately from Detroit as they provide services to the region. Further, the lien on the net System revenues and payments of amounts due on the Bonds during a City bankruptcy are given special protection under the terms of Chapter 9 of the bankruptcy code.

The financial health of Detroit, which is impaired despite the relative financial health of DWSD, would in Fitch's view not benefit from the cram down in any material way. In fact Fitch feels a cram down of the DWSD bonds would likely be harmful. Impairing otherwise healthy and performing special revenue debt despite the protections of federal, state and City law may make it more difficult for Detroit to issue special revenue obligations in the future.

Detroit filed a Sixth POA yesterday which generally reflects the tender process as described above. This Sixth POA provides some further information on a potential regional Authority for the operations of the System. Additionally, this POA indicates that to the extent any tendered Bonds are accepted and the process concludes, all DWSD Bonds will be unimpaired. However, if no tendered bonds are accepted then the impairment status for the Bonds generally reverts to that described in the Fifth POA.

Fitch currently rates the DWSD's senior and subordinate Bonds 'BB+' and 'BB', respectively. Fitch also has the Bonds on Rating Watch Negative.

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